DESCRIPTION OF SENATE FINANCE COMMITTEE CHAIRMAN'S MARK RELATING TO TAX SIMPLIFICATION PROVISIONS

Scheduled for Markup

Before the

SENATE COMMITTEE ON FINANCE

on June 19, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup of revenue reconciliation provisions, beginning on June 19, 1997. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for the tax simplification provisions in the following areas: (I) individuals, (II) businesses, (III) partnerships, (IV) real estate investment trusts, (V) repeal of the short-short test for regulated investment companies, (VI) taxpayer protections, (VII) estate, gift, and trust simplification, (VIII) excise tax and other simplification, (IX) pension simplification, and (X) foreign simplification.

Separate documents provide descriptions of revenue reconciliation and technical correction/ provisions of the Chairman's mark.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Senate Finance Committee Chairman's Mark Relating to Tax Simplification Provisions* (JCX-30-97), June 17, 1997.

I. PROVISIONS RELATING TO INDIVIDUALS

A. Modifications to Standard Deduction of Dependents; AMT Treatment of Certain Minor Children

Present Law

Standard deduction of dependents.--The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return shall not exceed the lesser of (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) or (2) the greater of $500 (indexed)[2] or the dependent's earned income (sec. 63(c)(5)).

Taxation of unearned income of children under age 14.--The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. The portion of the child's unearned income which is taxed at the parent's top marginal rate is the amount by which the child's unearned income is more than the sum of (1) $500[3] (indexed) plus (2) the greater of (a) $500[4] (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income (sec. 1(g)).

Alternative minimum tax ("AMT") exemption for children under age 14.--Single taxpayers are entitled to an exemption from the alternative minimum tax ("AMT") of $33,750. However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused alternative minimum tax exemption of the child's custodial parent, limited to sum of earned income and $1,400 (sec. 59(j)).

Description of Proposal

Standard deduction of dependents.--The proposal would provide that the standard deduction for a taxpayer with respect to whom a dependency exemption is allowed on another taxpayer's return would be the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500[5] (indexed for inflation as under present law), or (b) the individual's earned income plus $250. The $250 amount would be indexed for inflation after 1998.

Alternative minimum tax exemption for children under age 14.--The proposal would provide that the AMT exemption amount for a child under age 14 would be equal to the lesser of

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[2] The indexed amount is projected to be $700 for 1998.

[3] Projected to be $700 for 1998.

[4] Projected to be $700 for 1998.

[5] Projected to be $700 for 1998.

(1) $33,750 or (2) the sum of the child's earned income plus $5,000. The $5,000 amount would be indexed for inflation after 1998.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

B. Increase De Minimis Threshold for Estimated Tax to $1,000 for Individuals

Present Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax (sec. 6654). An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year. Income tax withholding from wages is considered to be a payment of estimated taxes. In general, payment of estimated taxes must be made quarterly. The addition to tax is not imposed where the total tax liability for the year, reduced by any withheld tax and estimated tax payments, is less than $500.

Description of Proposal

The proposal would increase the $500 individual estimated tax de minimis threshold to $1,000.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

C. Treatment of Certain Reimbursed Expenses of Rural Letter Carriers' Vehicles

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150 percent of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income.

Description of Proposal

The proposal would repeal the special rate for Postal Service employees of 150 percent of the standard mileage rate. In its place, the proposal would require that the rate of reimbursement provided by the Postal Service to rural letter carriers be considered to be equivalent to their expenses. The rate of reimbursement that would be considered to be equivalent to their expenses would be the rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

D. Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Description of Proposal

The one-year limitation with respect to deductibility of expenses while temporarily away from home would not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods would be fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Effective Date

The proposal would be effective for amounts paid or incurred with respect to taxable years ending after the date of enactment.

II. PROVISIONS RELATING TO BUSINESSES GENERALLY

A. Modifications to Look-Back Method for Long-Term Contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[6] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such

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[6] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

taxpayer to the change in gross income as recomputed under the look-back method.

Description of Proposal

Election not to apply the look-back method for de minimis amounts

The proposal would provide that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election would apply to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.--A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The proposal would provide that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract would not be discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election would apply to all long-term contracts completed during the taxable year for

which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.--A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the bill, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The proposal would provide that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The proposal would apply to contracts completed in taxable years ending after the date of enactment. The change in the interest rate calculation also would apply for purposes of the look-back method applicable to the income forecast method of depreciation.

B. Minimum Tax Treatment of Certain Property and Casualty Insurance Companies

Present Law

Present law provides that certain property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

Under present law, all corporations including insurance companies are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).

Description of Proposal

The proposal would provide that a property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company would be determined without regard to underwriting income (or underwriting expense, as provided in section 56(g)(4)(B)(i)(II)).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

C. Treatment of Construction Allowances Provided to Lessees

Present Law

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[7] This rule applies whether the lessor or lessee places the leasehold improvements in service.[8] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (l)(6)). A lessor of leased property that disposes of a leasehold improvement that was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease (sec. 168(i)(8)).

The gross income of a lessor of real property does not include any amount attributable to the value of buildings erected, or other improvements made by, a lessee that revert to the lessor at the termination of a lease (sec. 109).

Issues have arisen as to the proper treatment of amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to the lease ("construction allowances"). In general, incentive payments are includible in income as accessions to wealth.[9] A coordinated issue paper issued by the Internal Revenue Service ("IRS") on October 7, 1996, states the IRS position that construction allowances should generally be included in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's

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[7] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the Tax Reform Act of 1986.

[8] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[9] John B. White, Inc. v. Comm., 55 T.C. 729 (1971), aff'd per curiam 458 F. 2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972).

income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of the following factors: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates present obligations on the seller to execute and deliver a deed and on the buyer to make payments; (5) whether the right of possession is vested; (6) who pays property taxes; (7) who bears the risk of loss or damage to the property; (8) who receives the profits from the operation and sale of the property; (9) who carries insurance with respect to the property; (9) who is responsible for replacing the property the property; and (10) who has the benefits of any remainder interests in the property.

Description of Proposal

The proposal would provide that the gross income of a lessee does not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space. The exclusion only would apply to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. For this purpose, "qualified long-term real property" would mean nonresidential real property that is part of, or otherwise present at, retail space used by the lessee and that reverts to the lessor at the termination of the lease. A "short-term lease" would mean a lease or other agreement for the occupancy or use of retail space for a term of 15 years or less (as determined pursuant to sec. 168(i)(3)). "Retail space" would mean real property leased, occupied, or otherwise used by the lessee in its trade or business of selling tangible personal property or services to the general public.

The proposal would provide that lessor will treat the amounts expended on the construction allowance as nonresidential real property. However, the lessee's exclusion would not be dependent upon the lessor's treatment of the property as nonresidential real property.

The proposal would contain reporting requirements to ensure that both the lessor and lessee treat such amounts as nonresidential real property. Under regulations, the lessor and the lessee would, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provisions of the bill. It is expected that the Secretary, in promulgating such regulations, would attempt to minimize the administrative burdens of taxpayers while ensuring compliance with the proposal.

Effective Date

The proposal would apply to leases entered into after the date of enactment. No inference is intended as to the treatment of amounts that are not subject to the provision.

D. Shrinkage Allowances for Inventory Accounting

Present Law

Section 471(a) provides that "(w)henever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith.[10] The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as "shrinkage."

Some taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

If a physical inventory is taken at year-end, the amount of shrinkage for the year is known. If a physical inventory is not taken at year-end, shrinkage through year-end will have to be based on an estimate, or not taken into account until the following year. In the first decision in Dayton Hudson v. Commissioner,[11] the U.S. Tax Court held that a taxpayer's method of accounting may include the use of an estimate of shrinkage occurring through year-end, provided the method is sound and clearly reflects income. In the second decision in Dayton Hudson v. Commissioner,[12] the U.S. Tax Court adhered to this holding. However, the U.S. Tax Court in the second decision determined that this taxpayer had not established that its method of accounting clearly reflected income. Other cases decided by the U.S. Tax Court[13] have held that taxpayers' methods of accounting that included shrinkage estimates do clearly reflect income.

The U.S. Tax Court in the second Dayton Hudson opinion noted that "(I)n most cases, generally accepted accounting principles (GAAP), consistently applied, will pass muster for tax purposes. The Supreme Court has made clear, however, that GAAP does not enjoy a presumption of accuracy that must be rebutted by the Commissioner."

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[10] Treas. reg. sec. 1.471-2(d).

[11] 101 T.C. 462 (1993).

[12] T.C. Memo (filed June 11, 1997).

[13] Wal-Mart v. Commissioner, T.C. Memo 1997-1 and Kroger v. Commissioner, T.C. Memo 1997-2.

Description of Proposal

The proposal would provide that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer would be required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer would be required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment.

Under the proposal, a taxpayer would be permitted to change its method of accounting if the taxpayer is currently using a method that does not utilize estimates of inventory shrinkage and wishes to change to a method for inventories that includes shrinkage estimates based on physical inventories taken other than at year-end. The period for taking into account any adjustment required under section 481 as a result of such a change in method would be 4 years.

The proposal would intend no inference with regard to the validity of any method of keeping inventories under present law.

III. PARTNERSHIP SIMPLIFICATION PROVISIONS

A. General Provisions

1. Simplified flow-through for large partnerships

Present Law

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners.

Description of Proposal

The proposal would modify the tax treatment of an electing large partnership (generally, any partnership that elects under the proposal, if the number of partners in the preceding partnership taxable year is 100 or more) and its partners. The proposal would provide that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.[14] Separate treatment may be appropriate, for example, should changes in the law

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[14] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income would be

necessitate such treatment for any items.

Under the proposal, the taxable income of an electing large partnership would be computed in the same manner as that of an individual, except that the items described above would be separately stated and certain modifications would be made. These modifications would include disallowing the deduction for personal exemptions, the net operating loss deduction, and certain itemized deductions.[15] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and itemized deduction limitations, and any other proposal specified in regulations) would be applied at the partnership (and not the partner) level.

All elections affecting the computation of taxable income or any credit generally would be made by the partnership.

An "electing large partnership" would be any partnership that elects under the proposal, if the number of partners in the preceding partnership taxable year is 100 or more. The number of partners would be determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) would not be counted. To the extent so provided in regulations, if the number of partners in any taxable year falls below 100, the partnership would not be treated as an electing large partnership. The election apply to the year for which made and all subsequent years and could not be revoked without the Secretary's consent.

Service partnerships.--An electing large partnership would not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" would not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Commodity partnerships.--The election under these rules would not apply to any partnership the principal activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

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applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule would permit partnerships to make otherwise valid special allocations of partnership items to partners.

[15] An electing large partnership would be allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance. No income from an electing large partnership would be treated as fishing or farming income.

Partnerships holding oil and gas properties.--In general, an electing large partnership that is substantially engaged in oil and gas related activities would utilize the simplified reporting regime, as modified for oil and gas purposes. A partnership would be considered to be substantially engaged in oil and gas activities if at least 25 percent of the average value of its assets during the taxable year consists of oil or gas properties.[16] In making this determination, a partnership would be treated as owning its proportionate share of assets of any partnership in which it holds an interest. The proposal would provide special rules for large partnerships with oil and gas activities that operate under the simplified reporting regime (including electing large partnerships that are not substantially engaged in oil and gas operations, but do have some oil and gas activities).

Effective Date

Partnership taxable years beginning after December 31, 1997.

2. Simplified audit procedures for electing large partnerships

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

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[16] For this purpose, "oil or gas properties" means the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Description of Proposal

The proposal would create a new audit system for any partnership that is an electing large partnership. The proposal would define "electing large partnership" as any partnership that elects under the reporting provision, if the number of partners in the preceding partnership taxable year is 100 or more.

As under present law, electing large partnerships and their partners would be subject to unified audit rules. Thus, the tax treatment of "partnership items" would be determined at the partnership, rather than the partner, level. The term "partnership items" would be defined as under present law.

Unlike present law, however, partnership adjustments generally would flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits would be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally would not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally would be calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership).

Effective Date

Partnership taxable years beginning after December 31, 1997.

3. Due date for furnishing information to partners of electing large partnerships

Present Law

A partnership required to file an income tax return with the Internal Revenue Service must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a

partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Description of Proposal

The proposal would provide that an electing large partnership (i.e., one that elects under the reporting provision) must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year.

The proposal would also provide that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

Partnership taxable years beginning after December 31, 1997.

4. Partnership returns required on magnetic media

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Description of Proposal

The proposal would provide generally that any partnership is required to provide the tax return of the partnership (Form 1065), as well as copies of the schedule sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media. An exception would be provided for partnerships with 100 or fewer partners.

Effective Date

Partnership taxable years beginning after December 31, 1997.

5. Treatment of partnership items of individual retirement arrangements

Present Law

Return filing requirements

An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year (Treas. Reg. sec. 1.6012-3(a)(5)).

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions which are directly connected with the carrying on of such trade or business (sec. 512(a)(1). In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000 (sec. 512(b)(12)).

Unified audits of partnerships

All but certain small partnerships are subject to unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

Description of Proposal

The proposal would modify the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) would not be required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Effective Date

Taxable years beginning after December 31, 1997.

B. Other Partnership Audit Rules

1. Treatment of partnership items in deficiency proceedings

Present Law

Partnership proceedings under rules enacted in TEFRA[17] must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Description of Proposal

The proposal would overrule Munro and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This would eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and would restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the proposal would provide a special rule to address the factual situation presented in Munro.

Specifically, the proposal would provide a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return would be a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS would be authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS could

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[17] Tax Equity and Fiscal Responsibility Act of 1982.

only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax is due upon such a determination, but a decision of the Tax Court is treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that is deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS has preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the proposal would provide that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the proposal would incorporate a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures do not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings are controlling.

Effective Date

Partnership taxable years ending after the date of enactment.

2. Partnership return to be determinative of audit procedures to be followed

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal would permit the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the proposal would permit the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

Partnership taxable years ending after the date of enactment.

3. Provisions relating to statute of limitations

a. Suspend statute when an untimely petition is filed

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this proposal with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Description of Proposal

The proposal would conform the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the proposal, the statute of limitations in TEFRA cases would be suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension would remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period would no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

All cases in which the period of limitations has not expired under present law as of the date of enactment.

b. Suspend statute of limitations during bankruptcy proceedings

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this proposal only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension proposal in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay proposal of the Bankruptcy Code.

Description of Proposal

The proposal would clarify that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The proposal does not purport to create any inference as to the proper interpretation of present law.

Effective Date

All cases in which the period of limitations has not expired under present law as of the date of enactment.

c. Extend statute of limitations for bankrupt TMPs

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the Tax Matters Partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because

of the automatic stay proposal contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Description of Proposal

The proposal would provide that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who is the Tax Matters Partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases are binding on all of the partners in the partnership. The proposal is not intended to create any inference as to the proper interpretation of present law.

Effective Date

Effective for extension agreements entered into after the date of enactment.

4. Expansion of small partnership exception

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal would permit a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the proposal retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

Partnership taxable years ending after the date of enactment.

5. Exclusion of partial settlements from 1-year limitation on assessment

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Description of Proposal

The proposal would provide that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items is determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year is controlling with respect to all disputed partnership items for the partnership taxable year. The proposal does not purport to create any inference as to the proper interpretation of present law.

Effective Date

Settlements entered into after the date of enactment.

6. Extension of time for filing a request for administrative adjustment

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable proposal for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Description of Proposal

The proposal would provide that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

Effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Availability of innocent spouse relief in context of partnership proceedings

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Description of Proposal

The proposal would provide both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the proposal would provide that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse could request that the assessment be abated. Upon receipt of such a request, the assessment would be abated and any reassessment would be subject to the deficiency procedures. If an abatement is requested, the statute of limitations would not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court only would have jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question would be conclusive.

Alternatively, the proposal would provide that the spouse of a partner could file a claim for refund to raise the innocent spouse defense. The claim would have to be filed within 6 months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed, the spouse could file a refund action. For purposes of any claim or suit under this proposal, the treatment of the partnership items that gave rise to the liability in question would be conclusive.

Effective Date

Effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determination of penalties at partnership level

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Description of Proposal

The proposal would provide that the partnership-level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the proposal would allow partners to raise any partner-level defenses in a refund forum.

Effective Date

Effective for partnership taxable years ending after the date of enactment.

9. Provisions relating to Tax Court jurisdiction

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Description of Proposal

The proposal would clarify that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The proposal also would permit a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the proposal would clarify that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

Effective for partnership taxable years ending after the date of enactment.

10. Treatment of premature petitions filed by notice partners or 5-percent groups

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Description of Proposal

The proposal would treat premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

Effective with respect to petitions filed after the date of enactment.

11. Bonds in case of appeals from certain proceedings

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Description of Proposal

The proposal would clarify that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this proposal, the amount of the bond could be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

Effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspension of interest where delay in computational adjustment resulting from certain settlements

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Description of Proposal

The proposal would suspend interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

Effective with respect to adjustments relating to taxable years beginning after the date of enactment.

13. Special rules for administrative adjustment requests with respect to bad debts or worthless securities

Present Law

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) two years from the date the claimed tax was paid, whichever is later (sec. 6511(b)). However, an extended period of time, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (sec. 6511(d)).

Under the TEFRA partnership rules, a request for administrative adjustment ("RAA") must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (sec. 6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment ("FPAA") is mailed for the taxable year (sec. 6227(a)(2)). There is no special proposal for extending the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

Description of Proposal

The proposal would extend the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in section 6227(a)(1), the period for filing an RAA would be seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA would still be required to be filed before the FPAA is mailed for the taxable year.

Effective Date

Effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

C. Closing of Partnership Taxable Year With Respect to Deceased Partner

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See Estate of Hesse v. Commissioner, 74 T.C. 1307, 1311 (1980).

Description of Proposal

The proposal would provide that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The proposal would not change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

The proposal would apply to partnership taxable years beginning after December 31, 1997.

IV. MODIFICATIONS OF RULES FOR REAL ESTATE INVESTMENT TRUSTS (REITS)

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Election to be treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive

capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the

ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT Status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of a business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property

held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. reg. sec. 1.856-4(b)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REIT's ownership interest in a tenant, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange

for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income (described below).

Excess noncash items include (a) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Description of Proposal

Overview

The proposal would modify many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT.

Clarification of limitation on maximum number of shareholders

The proposal would replace the rule that disqualifies a REIT for any year in which the REIT failed to comply with regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty would be $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also would be required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, would not be treated as a personal holding company.

De minimis rule for tenant service income

The proposal would permit a REIT to render a *de minimis* amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts

received with respect to that property as rent. The value of the impermissible services could not exceed one percent of the gross income from the property. For these purposes, the services could not be valued at less than 150 percent of the REIT's direct cost of the services.

Attribution rules applicable to tenant ownership

The proposal would modify the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution would occur only when a partner owns a 25 percent or greater interest in the partnership.

Credit for tax paid by REIT on retained capital gains

The proposal would permit a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which could be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Repeal of 30-percent gross income requirement

The proposal would repeal the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Modification of earnings and profits for determining whether REIT has earnings and profits from non-REIT year

The proposal would change the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the proposal, distributions of accumulated earnings and profits generally would be treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions would not be treated as distributions for purposes of calculating the dividends paid deduction.

Treatment of foreclosure property

The proposal would lengthen the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request to the IRS. Under the proposal, a REIT

could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the proposal would conform the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Payments under hedging instruments

The proposal would treat income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) would be treated as qualifying income for purposes of the 95-percent test.

Excess noncash income

The proposal would (1) expand the class of excess noncash items to include income from the cancellation of indebtedness and (2) extend the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Prohibited transaction safe harbor

The proposal would exclude from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages

The proposal would provide that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within 4 years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless the REIT acquired the mortgage knew or had reason to know that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Wholly-owned REIT subsidiaries

The proposal would permit any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, the proposal would treat any such corporation as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of section 337). In addition, any pre-REIT earnings and profits of the subsidiary must be

distributed before the end of the REIT's taxable year.

Effective Date

The proposals would be effective for taxable years beginning after the date of enactment.

V. REPEAL THE SHORT-SHORT TEST FOR REGULATED INVESTMENT COMPANIES

Present Law

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Code provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income. In order to qualify for conduit treatment, the RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In particular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than three months (the "short-short test") (sec. 851(b)(3)).

Description of Proposal

The proposal would repeal the short-short test.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

VI. TAXPAYER PROTECTIONS

A. Provide Reasonable Cause Exception for Additional Penalties

Present Law

Many penalties in the Code may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty (sec. 6662) may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith (sec. 6664(c)).

Description of Proposal

The proposal would provide that the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:

(1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));

(2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));

(3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and

(4) the penalty for failure to make required payments for entities electing not to have the required taxable year (sec. 7519).

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

B. Clarification of Period for Filing Claims for Refunds

Present Law

The Code contains a series of limitations on tax refunds. Section 6511 of the Code provides both a limitation on the time period in which a claim for refund can be made (section 6511(a)) and a limitation on the amount that can be allowed as a refund (section 6511(b)). Section 6511(a) provides the general rule that a claim for refund must be filed within 3 years of the date of the return or 2 years of the date of payment of the taxes at issue, whichever is later. Section 6511(b) limits the refund amount that can be covered: if a return was filed, a taxpayer can recover amounts paid within 2 years before the claim. Section 6512(b)(3) incorporates these rules where taxpayers who challenge deficiency notices in Tax Court are found to be entitled to refunds.

In Commissioner v. Lundy, 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within 3 years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and the 2-year "look back" rule applied. Since overwithheld amounts are deemed paid as of the date the taxpayer's return was first due (i.e., more than 2 years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued, and then claimed a refund, the 3-year "look back" rule would apply, and the taxpayer could have obtained a refund of the overwithheld amounts.

Description of Proposal

The proposal would permit taxpayers who initially fail to file a return, but who receive a notice of deficiency and file suit to contest it in Tax Court during the third year after the return due date, to obtain a refund of excessive amounts paid within the 3-year period prior to the date of the deficiency notice.

Effective Date

The proposal would apply to claims for refund with respect to tax years ending after the date of enactment.

C. Repeal of Authority to Disclose Whether a Prospective Juror Has Been Audited

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Description of Proposal

The proposal would repeal the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The proposal would be effective for judicial proceedings commenced after the date of enactment.

D. Clarify Statute of Limitations for Items from Pass-Through Entities

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (Bufferd v. Comm., 113 S. Ct. 927 (1993)).

Description of Proposal

The proposal would clarify that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

E. Prohibition on Browsing

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized willful disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

There is no explicit criminal penalty in the Internal Revenue Code for unauthorized inspection (absent subsequent disclosure) of tax returns and return information. Such inspection is, however, explicitly prohibited by the Internal Revenue Service ("IRS").[18] In a recent case, an individual was convicted of violating the Federal wire fraud statute (18 U.S.C. 1343 and 1346) and a Federal computer fraud statute (18 U.S.C. 1030) for unauthorized inspection. However, the U.S. First Circuit Court of Appeals overturned this conviction.[19] Unauthorized inspection of information of any department or agency of the United States (including the IRS) via computer was made a crime under 18 U.S.C. 1030 by the Economic Espionage Act of 1996.[20] This provision does not apply to unauthorized inspection of paper documents.

Description of Proposal[21]

Criminal penalties

The proposal would create a new criminal penalty in the Internal Revenue Code. The penalty would be imposed for willful inspection (except as authorized by the Code) of any tax return or return information by any Federal employee or IRS contractor. The penalty also would apply to willful inspection (except as authorized) by any State employee or other person who acquired the tax return or return information under specific provisions of section 6103. Upon conviction, the penalty would be a fine in any amount not exceeding $1,000,[22] or imprisonment of not more than 1 year, or both, together with the costs of prosecution. In addition, upon

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[18] IRS Declaration of Privacy Principles, May 9, 1994.

[19] U.S. v. Czubinski, DTR 2/25/97, p. K-2.

[20] P.L. 104-294, sec. 201 (October 11, 1996).

[21] This proposal was passed by the House of Representatives and the Senate on April 15, 1997 (H.R. 1226).

[22] Pursuant to 18 U.S.C. sec. 3571 (added by the Sentencing Reform Act of 1984), the amount of the fine is not more than the greater of the amount specified in this new Code section or $100,000.

conviction, an officer or employee of the United States would be dismissed from office or discharged from employment.

Civil damages

The proposal would amend the provision providing for civil damages for unauthorized disclosure by also providing for civil damages for unauthorized inspection. Damages would be available for unauthorized inspection that occurs either knowingly or by reason of negligence. Accidental or inadvertent inspection that may occur (such as, for example, by making an error in typing in a TIN) would not be subject to damages because it would not meet this standard. The proposal also would provide that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The proposal also would require that, if any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of section 7213(a) or (b), section 7213A (as added by the proposal), or 18 USC section 1030(a)(2)(B), the Secretary notify that taxpayer as soon as practicable of the inspection or disclosure.

Effective Date

The proposal would be effective for violations occurring on or after the date of enactment.

VII. ESTATE, GIFT, AND TRUST TAX SIMPLIFICATION

1. Eliminate gift tax filing requirements for gifts to charities

Present Law

A gift tax generally is imposed on lifetime transfers of property by gift (sec. 2501). In computing the amount of taxable gifts made during a calendar year, a taxpayer generally may deduct the amount of any gifts made to a charity (sec. 2522). Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of certain partial interests in property (such as a remainder interest). A gift of a partial interest in property must be in a prescribed form in order to qualify for the deduction.

Individuals who make gifts in excess of $10,000 to any one donee during the calendar year generally are required to file a gift tax return (sec. 6019). This filing requirement applies to all gifts, whether charitable or noncharitable, and whether or not the gift qualifies for a gift tax charitable deduction. Thus, under current law, a gift tax return is required to be filed for gifts to charity in excess of $10,000, even though no gift tax is payable on the transfer.

Description of Proposal

Gifts to charity would not be subject to the gift tax filing requirements of section 6019, as long as the entire value of the transferred property qualifies for the gift tax charitable deduction under section 2522. The filing requirements for gifts of partial interests in property would remain unchanged.

Effective Date

The proposal would be effective for gifts made after the date of enactment.

2. Clarification of waiver of certain rights of recovery

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

A decedent's gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the

inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Description of Proposal

The proposal would provide that the right of recovery with respect to QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates. Thus, a general provision specifying that all taxes be paid by the estate would no longer be sufficient to waive the right of recovery. The proposal also would provide that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedent's will or revocable trust, but specific reference to section 2207B would no longer be required.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

3. Transitional rule under section 2056A

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Description of Proposal

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 would be treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The proposal would apply as if included in the Omnibus Budget Reconciliation Act of 1990.

4. Treatment for estate tax purposes of short-term obligations held by nonresident aliens

Present Law

The United States imposes estate tax on assets of noncitizen nondomiciliaries that were situated in the United States at the time of the individual's death. Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualifies for the bank deposit interest exemption and the portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of these special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. However, because of an amendment to section 871(h) made by the Tax Reform Act of 1986, these special rules no longer cover obligations that generate short-term OID income despite the fact that such income is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(i)).

Description of Proposal

Any debt obligation the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) if such income were received by the decedent on the date of his death would be treated as property located outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen. No inference is intended with respect to the estate tax treatment of such obligations under present law.

Effective Date

The proposal would be effective for estates of decedents dying after the date of enactment.

5. Distributions during first 65 days of taxable year of estate

Present Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not

estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Description of Proposal

The proposal would extend application of the 65-day rule to distributions by estates. Thus, an executor could elect to treat distributions paid within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

6. Separate share rules available to estates

Present Law

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus.[23] Treasury regulations provide that "[t]he application of the separate share rule . . . will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. . . . Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist." (Treas. Reg. sec. 1.663(c)-3). The separate share rule presently does not apply to estates.

[23] Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

Description of Proposal

The proposal would extend the application of the separate share rule to estates. There would be separate shares in an estate when the governing instrument of the estate creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

7. Executor of estate and beneficiaries treated as related persons for disallowance of losses

Present Law

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For the purposes of section 267, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50 percent owned by the trust or the trust's grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest.

Neither section 267 or section 1239 presently treat an estate and a beneficiary of the estate as related persons.

Description of Proposal

Under the proposal, an estate and a beneficiary of that estate would be treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

8. Simplified taxation of earnings of pre-need funeral trusts

Present Law

A pre-need funeral trust is an arrangement where an individual purchases funeral or burial services or merchandise from a funeral home or cemetery in advance of the individual's death. The individual enters into a contract with the provider of such services or merchandise whereby the individual selects the services or merchandise to be provided upon his or her death, and agrees to pay for them in advance of his or her death. Such amounts (or a portion thereof) are held in trust during the individual's lifetime and are paid to the seller upon the individual's death.

Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is taxed to the purchaser/grantor of the trust. Rev. Rul. 87-127. Any amount received from the trust by the seller (as payment for services or merchandise) is includible in the gross income of the seller.

Description of Proposal

The trustee of a pre-need funeral trust would be allowed to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust would be defined as one which meets the following requirements: (1) the trust arises as the result of a contract between a person engaged in the trade or business of providing funeral or burial services or merchandise and one or more individuals to have such services or property provided upon such individuals' death; (2) the only beneficiaries of the trust are individuals who have entered into contracts to have such services or merchandise provided upon their death; (3) the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For contracts entered into after 1998, the $7,000 limit would be indexed annually for inflation.

The trustee's election to have this provision apply to a qualified funeral trust would be made separately with respect to each purchaser's trust. An electing trust would not be treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust would be determined in accordance with the income tax rate schedule generally applicable to estates and trusts (Code sec. 1(e)), but no deduction would be allowed under section 642(b). The tax on the annual earnings of the trust would be payable by the trustee.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

9. Adjustments for gifts within three years of decedent's death

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). There has been significant litigation as to whether these rules require that certain transfers made from a revocable trust within three years of death be includible in the gross estate. See, e.g., Jalkut Estate v. Commissioner, 96 T.C. 675 (1991) (transfers from revocable trust includible in gross estate); McNeely v. Commissioner, 16 F.3d 303 (8th Cir. 1994) (transfers from revocable trust not includible in gross estate); Kisling v. Commissioner, 32 F.3d 1222 (8th Cir. 1994) (acq.) (transfers from revocable trust not includible in gross estate).

Description of Proposal

The proposal would codify the rule set forth in the McNeely and Kisling cases to provide that a transfer from a revocable trust (i.e., a trust described under section 676) would be treated as if made directly by the grantor. Thus, an annual exclusion gift from such a trust would not be included in the gross estate.

The proposal also would revise section 2035 to improve its clarity.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

10. Clarify relationship between community property rights and retirement benefits

Present Law

Community property

Under state community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in either his or her spouse's qualified plan, individual retirement arrangement ("IRA"), or simplified employee pension ("SEP") plan.

Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 ("REA"), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a

preretirement survivor annuity. A participant generally is permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

Description of Proposal

The proposal would clarify that the marital deduction is available with respect to a nonparticipant spouse's interest in an IRA, SEP, or qualified pension plan (collectively hereinafter referred to as a "plan") attributable to community property laws where he or she predeceases the participant spouse. Under the proposal, the nonparticipant spouse's interest in a plan that passes to the surviving participant spouse is deemed to qualify for treatment as qualified terminable interest property (QTIP) under section 2056(b)(7).[24]

Effective Date

The proposal would apply to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.

11. Treatment under qualified domestic trust rules of forms of ownership which are not trusts

Present Law

A marital deduction generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The marital deduction is not available for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

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[24] In general, QTIP is property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and which the executor elected to treat as QTIP. A surviving spouse generally has a qualifying income interest for life if he or she is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse.

Trusts are not permitted in some countries (e.g., many civil law countries).[25] As a result, it is not possible to create a QDT in those countries.

Description of Proposal

The proposal would provide the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

12. Opportunity to correct certain failures under section 2032A

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Treasury Department, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department.

Description of Proposal

The proposal would extend the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the regulations. Thus, the proposal would allow the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the proposal also would allow the addition of signatures to a previously filed agreement. No

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[25] Note that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct, exists.

inference would be intended as to whether the Treasury Department already has the authority to adopt this position under present law.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

13. Authority to waive requirement of U.S. trustee for qualified domestic trusts

Present Law

In order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts cannot have any U.S. trustees. As a result, trusts established in those countries cannot qualify as a QDT.

Description of Proposal

In order to permit the establishment of a QDT in countries that prohibit a trust from having a U.S. trustee, the proposal would provide the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, would provide an alternative mechanism under which the U.S. would retain jurisdiction to impose gift and estate tax on transfers by the surviving spouse of the property transferred by the deceased spouse.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

VIII. EXCISE TAX AND OTHER SIMPLIFICATION PROVISIONS

A. Increase De Minimis Limit for After-Market Alterations Subject to Heavy Truck and Luxury Automobile Excise Taxes

Present Law

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight of over 33,000 pounds. The tax is equal to 12 percent of the retail sales price. An excise tax also is imposed on retail sales of luxury automobiles. The tax currently is equal to 8 percent of the amount by which the retail sales price exceeds an inflation-adjusted $30,000 base. (The rate is reduced by 1 percentage point per year through 2002, and the tax is not imposed after 2002.) Anti-abuse rules prevent the avoidance of these taxes through separate purchases of major component parts. With certain exceptions, tax at the rate applicable to the vehicle is imposed on the subsequent installation of parts and accessories within six months after purchase of a taxable vehicle. The exceptions include a de minimis exception for parts and accessories with an aggregate price that does not exceed $200 (or such other amount as Treasury may by regulation prescribe).

Description of Proposal

The tax on subsequent installation of parts and accessories would not apply to parts and accessories with an aggregate price that does not exceed $1,000. Parts and accessories installed on a vehicle on or before that date would be taken into account in determining whether the $1,000 threshold is exceeded. If the aggregate price of the pre-effective date parts and accessories does not exceed $200, they would not be subject to tax unless the aggregate price of all additions exceeds $1,000.

Effective Date

The increase in the threshold for taxing after-market additions under the heavy truck and luxury car excise taxes would be effective on January 1, 1998.

B. Simplification of Excise Taxes on Distilled Spirits, Wine, and Beer

Present Law

Imported distilled spirits returned to plant.-- Excise tax that has been paid on domestic distilled spirits is credited or refunded if the spirits are later returned to bonded premises. Tax is imposed on imported bottled spirits when they are withdrawn from customs custody, but the tax is not refunded or credited if the spirits are later returned to bonded premises.

Cancellation of export bonds.--An exporter that withdraws distilled spirits from bonded warehouses for export or transportation to a customs bonded warehouse without the payment of tax must furnish a bond to cover the withdrawal. The required bonds are canceled "on the submission of such evidence, records, and certification indicating exportation as the Secretary may by regulations prescribe."

Location of records of distilled spirits plant.-- Proprietors of distilled spirits plants are required to maintain records and reports relating to their production, storage, denaturation, and processing activities on the premises where the operations covered by the record are carried on.

Transfers from brewery to distilled spirits plant.--A distilled spirits plant may receive on its bonded premises beer to be used in the production of distilled spirits only if the beer is produced on contiguous brewery premises.

Sign not required for wholesale dealers.--Wholesale liquor dealers are required to post a sign identifying the firm as such. Failure to do so is subject to a penalty.

Refund on returns of merchantable wine.--Excise tax paid on domestic wine that is returned to bond as unmerchantable is refunded or credited, and the wine is once again treated as wine in bond on the premises of a bonded wine cellar.

Increased sugar limits for certain wine.--Natural wines may be sweetened to correct high acid content. For most wines, however, sugar cannot constitute more than 35 percent (by volume) of the combined sugar and juice used to produce the wine. Up to 60 percent sugar may be used in wine made from loganberries, currants, and gooseberries. If the amount of sugar used exceeds the applicable limitation, the wine must be labeled "substandard."

Beer withdrawn for embassy use.--Imported beer to be used for the family and official use of representatives of foreign governments or public international organizations may be withdrawn from customs bonded warehouses without payment of excise tax. No similar exemption applies to domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use.

Beer withdrawn for destruction.--Removals of beer from a brewery are exempt from tax if the removal is for export, because the beer is unfit for beverage use, for laboratory analysis,

research, development and testing, for the brewer's personal or family use, or as supplies for certain vessels and aircraft.

Drawback on exported beer.--A domestic producer that exports beer may recover the tax (receive a "drawback") found to have been paid on the exported beer upon the "submission of such evidence, records and certificates indicating exportation" required by regulations.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.--Imported beer and wine are subject to tax when removed from customs custody.

Description of Proposals

Imported distilled spirits returned to plant.--Refunds or credits of the tax would be available for imported bottled spirits that are returned to distilled spirits plants.

Cancellation of export bonds.--The certification requirement would be relaxed to allow the bonds to be canceled if there is such proof of exportation as the Secretary may require.

Location of records of distilled spirits plant.--Records and reports would be permitted to be maintained elsewhere other than on the plant premises

Transfers from brewery to distilled spirits plant.--Beer may could be brought from any brewery for use in the production of spirits. Such beer would be exempt from excise tax, subject to Treasury regulations.

Sign not required for wholesale dealers.--The requirement that a sign be posted would be repealed.

Refund on returns of merchantable wine.--A refund or credit would be available in the case of all domestic wine returned to bond, whether or not unmerchantable.

Increased sugar limits for certain wine.--Up to 60 percent sugar would be permitted in any wine made from juice, such as cranberry or plum juice, with an acid content of 20 or more parts per thousand.

Beer withdrawn for embassy use. Subject to Treasury's regulatory authority, an exemption similar to that currently available for imported beer would be provided for domestic beer.

Beer withdrawn for destruction. An exemption from tax would be added for removals for destruction, subject to Treasury regulations.

Drawback on exported beer. The certification requirement would be relaxed to allow a drawback of tax paid if there is such proof of exportation as the Secretary may be regulations require.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries. Subject to Treasury regulations, beer and wine imported in bulk could be withdrawn from customs custody and transferred in bulk to a brewery (beer) or a winery (wine) without payment of tax. The proprietor of the brewery to which the beer is transferred or of the winery to which the wine is transferred would be liable for the tax imposed on the withdrawal from customs custody and the importer would be relieved of liability.

Effective Date

The proposal to repeal the requirement that wholesale liquor dealers post a sign outside their place of business would take effect on the date of enactment. The other proposals would take effect on the first day of the calendar quarter that begins at least 90 days after the date of enactment.

C. Other Excise Tax Provisions

1. Authority for Internal Revenue Service to grant exemptions from excise tax registration requirements

Present Law

The Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for use by a State or local government or a nonprofit educational organization) from excise taxes imposed on manufacturers and retailers. These exemptions generally apply only if the seller, the purchaser, and any person to whom the article is resold by the purchaser (the second purchaser) are registered with the Internal Revenue Service. The IRS can waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Description of Proposal

The IRS would be authorized to waive the registration requirement for purchasers and second purchasers in all cases.

Effective Date

The proposal would apply to sales made pursuant to waivers issued after the date of enactment.

2. Repeal of excise tax deadwood provisions

Present Law

The Code includes a provision relating to a temporary reduction in the tax on piggyback trailers sold before July 18, 1985, and provisions relating to the tax on the removal of hard minerals from the deep seabed before June 28, 1990.

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (sec. 4681). The amount of the tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount was $5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter. The Code contains provisions for special rates of tax applicable to years before 1996 (e.g., sec. 4282(g)(1), (2), (3), and (5)).

Description of Proposal

These provisions would be repealed, as deadwood.

Effective Date

The provisions would be effective on the date of enactment.

3. Modifications to excise tax on certain arrows

Present Law

An 11-percent excise tax is imposed on bows having a draw weight of more than 10 pounds and on arrows that either are greater than 18 inches in length or are suitable for use with a taxable bow.

Description of Proposal

To reduce the number of collection points for the tax on arrows, the tax would be replaced with a manufacturer's excise tax on the four component parts of the arrow: shafts, points, nocks, and vanes. The tax rate would be increased to 12.4 percent of the value of each of these four components to offset the reduction in aggregate value subjected to tax.

Effective Date

The proposal would be effective for arrow components sold after September 30, 1997.

4. Modifications to heavy highway vehicle retail excise tax

Present Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. Small trucks (those with a gross vehicle weight not over 33,000 pounds) and lighter trailers (those with a gross vehicle weight not over 26,000 pounds) are exempt from the tax. The tax applies to the first retail sale of a new or remanufactured vehicle. The determination under present law of whether a particular modification to an existing vehicle constitutes remanufacture (taxable) or a repair (nontaxable) is factual and generally is based on whether the function of the vehicle is changed or, in the case of worn vehicles, whether the cost of the modification exceeds 75 percent of the value of the modified vehicle.

No tax is imposed on trucks, tractors, and trailers when they are sold for resale or long-term lease, if the purchaser is registered with the Treasury Department. In such cases, purchasers are liable for the tax when the vehicle is sold or leased. The tax is based on the sales price in the transaction to which it applies.

Description of Proposal

The proposal would make two changes to the heavy vehicle excise tax:

(1) Clarification would be provided that the 75-percent-of-value threshold applies in determining whether repairs to a wrecked vehicle constitute remanufacture.

(2) The registration requirement currently applicable to certain sales for resale would be replaced with a certification requirement.

Effective Date

The proposal would be effective after December 31, 1997.

5. Clarify treatment of skydiving flights as noncommercial aviation

Present Law

Commercial passenger aviation, or air transportation for which a fare is charged, is subject to a 10-percent ad valorem excise tax for the Airport and Airway Trust Fund. General aviation, or air transportation which is not "for hire" is subject to a fuels tax for the Trust Fund. In the case of skydiving flights, questions have arisen as to when the flight is commercial aviation subject to the ticket tax and when it is noncommercial aviation subject to the fuels tax. In general, if instruction is offered, the flight is general aviation. Otherwise, the flight is commercial aviation. Many flights carry both persons receiving instruction and others.

Description of Proposal

The proposal would clarify that flights which are exclusively dedicated to skydiving are taxed as noncommercial aviation flights, regardless of whether instruction is offered to any of the passengers.

Effective Date

The proposal would be effective for flights beginning after September 30, 1997.

6. Eliminate double taxation of certain aviation fuels sold to producers by "fixed base operators"

Present Law

Section 4091 imposes a tax on the sale of aviation fuel by any producer (defined to include a wholesale distributor). Fuel sold at many rural airports is sold by retail dealers who do not qualify as wholesale distributors. This fuel is purchased by the retailers tax-paid. In certain instances, fuel which has been purchased tax-paid by a retailer will be re-sold to a producer, e.g., to enable to producer to serve one of its customers at the airport. When this fuel is resold at retail by the producer, a second tax is imposed. The Code contains no provision allowing a refund of the first tax in such cases.

Description of Proposal

The proposal would permit a refund of the tax previously paid on aviation fuel when a producer acquires the fuel, re-sells it, and pays tax on the second sale.

Effective Date

The proposal would be effective for fuel sold after September 30, 1997.

D. Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on these bonds to be excluded from gross income.

1. Repeal of $100,000 limitation on unspent proceeds under 1-year exception from rebate

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Description of Proposal

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement would be deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception would be deemed to be satisfied.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

Description of Proposal

The proposal would exempt earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

3. Repeal of debt service-based limitation on investment in certain nonpurpose investments

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage restrictions on investment of their bond proceeds. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to ten percent of such proceeds. The second set of arbitrage restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government. Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Description of Proposal

The proposal would repeal the 150-percent of debt service yield restriction.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

4. Repeal of expired provisions relating to student loan bonds

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

Description of Proposal

These special exceptions would be repealed as "deadwood."

Effective Date

The proposal would apply to bonds issued after the date of enactment.

E. Tax Court Procedures

1. Overpayment determinations of Tax Court

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Description of Proposal

The proposal would clarify that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The proposal also would clarify that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The proposal would be effective on the date of enactment.

2. Redetermination of interest pursuant to motion

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Description of Proposal

The proposal would provide that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The proposal would be effective on the date of enactment.

3. Application of net worth requirement for awards of litigation costs

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return.

Description of Proposal

The proposal would provide that the net worth limitations currently applicable to individuals also apply to estates and trusts. The proposal also would provide that individuals who file a joint tax return shall be treated as separate individuals for purposes of computing the net worth limitations.

Effective Date

The proposal would apply to proceedings commenced after the date of enactment.

4. Tax Court jurisdiction for determination of employment status

Present Law

The Tax Court is a court of limited jurisdiction, established under Article I of the Constitution. The Tax Court only has the jurisdiction that is expressly conferred on it by statute (sec. 7442).

Description of Proposal

The proposal would provide that, in connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (a) one or more individuals performing services for that person are employees of that person or (b) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court would have jurisdiction to determine whether the IRS is correct. For example, one way the IRS could make the required determination is through a mechanism similar to the employment tax early referral procedures.[26]

The proposal would provide for de novo review (rather than review of the administrative record). Assessment and collection of the tax would be suspended while the matter is pending in the Tax Court. Any determination by the Tax Court would have the force and effect of a decision of the Tax Court and would be reviewable as such; accordingly, it would be binding on the parties. Awards of costs and certain fees (pursuant to section 7430) would be available to eligible taxpayers with respect to Tax Court determinations pursuant to this proposal. The proposal would also provide a number of procedural rules to incorporate this new jurisdiction within the existing procedures applicable in the Tax Court.

Effective Date

The proposal would take effect on the date of enactment.

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[26] See Announcement 96-13 and Announcement 97-52.

F. Other Provisions

1. Due date for first quarter estimated tax payments by private foundations

Present Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to two percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940 (as well as any unrelated business income tax (UBIT) liability under section 511).[27] Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15th. Under section 6655(I), foundations with taxable years other than the calendar year must make their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

Description of Proposal

The proposal would amend section 6655(g)(3) to provide that a calendar-year foundation's first-quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990-PF, for the preceding year is due). As a result of the operation of present-law section 6655(I), fiscal-year foundations would be required to make their first-quarter estimated tax payment no later than the 15th day of the fifth month of their taxable year.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

2. Withholding of Commonwealth income taxes from the wages of Federal employees

Present Law

If State law provides generally for the withholding of State income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of Federal employees in the State. For this purpose, a State is a State, territory, or possession of the United States. The Court of Appeals for the Federal Circuit recently held in Romero v. United States (38 F. 3d 1204 (1994)) that Puerto Rico was not encompassed within this definition; consequently, the court invalidated an agreement between the Secretary of the

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[27] Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of (1) the preceding year's tax liability, as shown on the foundation's Form 990-PF, or (2) 95 percent of the foundation's current-year tax liability.

Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of Federal employees.

Description of Proposal

The proposal would make any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of Federal employees.

Effective Date

The proposal would be effective January 1, 1998.

3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments

Present Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency.

Description of Proposal

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice would be disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Effective Date

The proposal would be effective for purposes of determining interest for periods after December 31, 1997.

IX. PENSION SIMPLIFICATION

1. Matching contributions of self-employed individuals not treated as elective deferrals

Present Law

Under present law, matching contributions made under a partnership 401(k) plan are generally treated as additional elective contributions by a partner who receives the matching contribution. Accordingly, elective contributions and matching contributions for partners are subject to the section 401(k) limits on elective contributions ($9,500 for 1997).

Description of Proposal

The proposal would provide that matching contributions for partners in 401(k) plans will be treated the same as matching contributions for employees, i.e., they would not be treated as elective contributions and would not be subject to the elective contribution limit.

Effective Date

The proposal would be effective for years beginning after December 31, 1997.

2. Contributions to IRAs through payroll deductions

Present Law

Under present law, employer involvement in the establishment or maintenance of individual retirement arrangements ("IRAs") of its employees can result in the employer being considered to maintain a retirement plan for purposes of title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), thus subjecting the employer to ERISA's fiduciary rules.

Description of Proposal

The proposal would provide that an employer that facilitates IRA contributions by its employees by establishing a system under which employees, through employer payroll deductions, may make contributions to IRAs will not be considered to sponsor a retirement plan subject to ERISA. Under the system, employees would be required to provide their employer with a contribution certificate which establishes the IRA and specifies the contribution amount to be deducted from the employee's wages and remitted to the employee's IRA. As under present law, the amount contributed through payroll deduction would be includible in the employee's gross income and wages for employment tax purposes, and deductible by the employee in accordance with the rules relating to IRAs.

The proposal would not apply to self-employed individuals or an employee employed by

an employer who maintains a tax-qualified retirement plan.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

3. Plans not disqualified merely by accepting rollover contributions

Present Law

Under present law, a qualified retirement plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified. The receiving plan can reasonably conclude that the distributing plan was qualified if, for example, prior to accepting the rollover, the distributing plan provided a statement that the distributing plan had a favorable determination letter issued by the Internal Revenue Service ("IRS"). The receiving plan is not required to verify this information.

Description of Proposal

The proposal would clarify the circumstances under which a qualified plan could accept rollover contributions without jeopardizing its qualified status. Under the proposal, if the trustee of the plan making the distribution verifies that the distributing plan is intended to be a qualified plan, the plan receiving the rollover will not be disqualified if the distributing plan was not in fact a qualified plan.

Effective Date

The proposal would be effective for rollover contributions made after December 31, 1997.

4. Modification of prohibition on assignment or alienation

Present Law

Under present law, amounts held in a qualified retirement plan for the benefit of a participant are not, except in very limited circumstances, assignable or available to personal creditors of the participant. A plan may permit a participant, at such time as benefits under the plan are in pay status, to make a voluntary revocable assignment of an amount not in excess of 10-percent of any benefit payment. In addition, a plan may comply with a qualified domestic relations order issued by a state court requiring benefit payments to former spouses or other "alternate payees" even if the participant is not in pay status.

Description of Proposal

The proposal would permit a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant is being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of title I of the Employee Retirement Income Security Act, as amended ("ERISA"), or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset would be required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50-percent survivor annuity for the spouse.

Effective Date

The proposal would be effective for judgments, orders, and degrees issued, and settlement agreements entered into, on or after the date of enactment.

5. Elimination of paperwork burdens on plans

Present Law

Under present law, employers are required to prepare summary plan descriptions of employee benefit plans ("SPDs"), and summaries of material modifications to such plans ("SMMs"). The SPDs and SMMs generally provide information concerning the benefits provided by the plan and the participants' rights and obligations under the plan. The SPDs and SMMs must be furnished to plan participants and beneficiaries and filed with the Secretary of Labor.

Description of Proposal

The proposal would eliminate the requirement that SPDs and SMMs be filed with the Secretary of Labor. Employers would be required to furnish these documents to the Secretary of Labor upon request. A civil penalty could be imposed by the Secretary of Labor on the plan administrator for failure to comply with such requests. The penalty would be up to $100 per day of failure, up to a maximum of $1,000 per request. No penalty would be imposed if the failure was due to matters reasonably outside the control of the plan administrator.

Effective Date

The proposal would be effective on the date of enactment.

6. Modification of section 403(b) exclusion allowance to conform to section 415 modifications

Present Law

Under present law, annual contributions to a section 403(b) annuity cannot exceed the exclusion allowance. In general, the exclusion allowance for a taxable year is the excess, if any, of (1) 20 percent of the employee's includible compensation multiplied by his or her years of service, over (2) the aggregate employer contributions for an annuity excludable for any prior taxable years. Includible compensation means the amount of compensation from the employer that is includible in gross income for the most recent year that can be counted as a year of service.

Alternatively, an employee may elect to have the exclusion allowance determined under the rules relating to tax-qualified defined contribution plans (sec. 415). Under those rules, the maximum annual addition that can be made to a define contribution plan is the lesser of (1) $30,000 or 25 percent of compensation. For years beginning after December 31, 1996, compensation for this purpose includes certain elective deferrals of the employee. An overall limitation applies if the employee is a participant in both a defined contribution plan and a defined benefit plan of the same employer. This overall limitation may further reduce the maximum annual addition that could be made to a defined contribution plan. The overall limitation is repealed with respect to years beginning after December 31, 1999. Existing Treasury regulations relating to the alternative method of determining the exclusion allowance refer to the overall limit.

Description of Proposal

The proposal would conform the exclusion allowance to the way in which the section 415 limit is calculated by providing that includible compensation includes elective deferrals of the employee, and contributions made at the election of the employee to an unfunded deferred compensation plan of a tax-exempt or State or local government (a sec. 457 plan) or a cafeteria plan.

The proposal would direct the Secretary to revise the regulations regarding the exclusion allowance to reflect the fact that the overall limit on benefits and contributions is repealed. The revised regulations are to be effective for limitation years beginning after December 31, 1999.

Effective Date

The modification to the definition of includible compensation would be effective for years beginning after December 31, 1997. The direction to the Secretary would be effective on the date of enactment.

7. New technologies in retirement plans

Present Law

Under present law it is not clear if sponsors of employee benefit plans may use new technologies (telephonic response systems, computers, email) to satisfy the various ERISA requirements for notice, election, consent, record keeping, and participant disclosure.

Description of Proposal

The proposal would direct the Secretaries of the Treasury and Labor to issue coordinated guidance facilitating the use of new technology for plan purposes. The guidance would be designed to permit the use of new technologies by plan sponsors while maintaining the protection of the rights of participants and beneficiaries. The guidance would also clarify the extent to which State laws requiring paper transactions with respect to retirement plans are preempted and the extent to which writing requirements under the Internal Revenue Code shall be interpreted to permit paperless transactions.

Effective Date

The proposal would be effective on the date of enactment and would require that the coordinated guidance be issued not later than July 1, 1998.

8. Permanent moratorium on application of nondiscrimination rules to governmental plans

Present Law

Under present law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination and minimum participation rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination rules apply to all governmental plans; qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans).

For purposes of satisfying the nondiscrimination rules, the Internal Revenue Service has issued several Notices which extended the effective date for compliance for governmental plans. Governmental plans will be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

Description of Proposal

The proposal would provide that governmental plans are exempt from the nondiscrimination and minimum participation rules.

Effective Date

The proposal would be effective for taxable years beginning on and after the date of enactment.

9. Clarification of certain rules relating to employee stock ownership plans of S corporations

Present Law

Under present law, an S corporation can have no more than 75 shareholders. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation.

ESOPs are generally required to make distributions in the form of employer securities. If the employer securities are not readily tradable, the employee has a right to require the employer to buy the securities. In the case of an employer whose bylaws or charter restricts ownership of substantially all employer securities to employees or a pension plan, the plan may provide that benefits are distributed in the form of cash. Such a plan may distribute employer securities, if the employee has a right to require the employer to purchase the securities.

ESOPs are subject to certain prohibited transaction rules designed to prohibit certain transactions between the plan and certain persons close to the plan. A number of statutory exceptions are provided to the prohibited transaction rules, including exceptions for loans between the plan and plan participants and certain sales of stock to the ESOP. These statutory exceptions do not apply to shareholder-employees of S corporations. However, such individuals can obtain an administrative exception from such rules from the Department of Labor.

Description of Proposal

The proposal would provide that ESOPs of S corporations may distribute cash to plan participants. In addition, the proposal would extend the exception to certain prohibited transactions rules to S corporations.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

10. Modification of 10-percent tax on nondeductible contributions

Present Law

Under present law, contributions to qualified pension plans are deductible within certain limits. In the case of a single-employer defined benefit plan which has more than 100 participants during the year, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules. Limits are also imposed on the amount of annual deductible contributions if an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees. Under the combined plan limitation, the total deduction for all plans for a plan year is generally limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defied benefit plan for the year.

A 10-percent nondeductible excise tax is imposed on contributions that are not deductible. This excise tax does not apply to contributions to one or more defined contribution plans that are nondeductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed 6 percent of compensation in the year for which the contribution is made.

Description of Proposal

The proposal would add an additional exception to the 10-percent excise tax on nondeductible contributions. Under the proposal, the excise tax would not apply to contributions to one or more defined contribution plans that are not deductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed the amount of the employer's matching contributions plus the elective deferral contributions to a section 401(k) plan.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 1997.

11. Modification of funding requirements for certain plans with significant mortality differences

Present Law

Under present law, defined benefit pension plans are required to meet certain minimum funding rules. Underfunded plans are required to satisfy certain faster funding requirements. In general, these additional requirements do not apply in the case of plans with a funded current liability percentage of at least 90 percent.

The Pension Benefit Guaranty Corporation ("PBGC") insured benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

Description of Proposal

The proposal would modify the minimum funding requirements in the case of certain plans. The proposal would apply in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) does not, in plan years beginning after 1995 and before 2009, merged with another plan (other than a plan sponsored by a an employer that was a member of the controlled group of the employer in 1996), and is sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The proposal treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90 percent if the actual funded current liability percentage is at least as follows:

Plan year beginning in:	Minimum percentage
2005	86
2006	87
2007	88
2008	89
2009 and thereafter	90

If the funded current liability percentage falls below 85 percent for a plan year beginning before 2005, the rule described above would still apply if contributions for any such year are made to the plan in an amount equal to the lesser of: (1) the amount necessary to bring the funded current liability percentage to 85 percent, or (2) the greater of (a) 2 percent of the plans' current liability as of the beginning of such plan year or (b) the amount necessary to bring the funded current liability percentage to 80 percent as of the end of such plan year.

The relief from the minimum funding requirements applies for the plan year beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

Effective Date

The proposal would be effective for plan years beginning after December 31, 1997.

X. FOREIGN SIMPLIFICATION

1. General provisions affecting treatment of controlled foreign corporations

Present Law

If an upper-tier controlled foreign corporation ("CFC") sells stock of a lower-tier CFC, the gain generally is included in the income of U.S. 10-percent shareholders as subpart F income and such U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion. The inclusion is not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead it generally is characterized as passive income.

For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC and, except as provided in regulations, the recipient of the distribution was a U.S. 10-percent shareholder in such corporation.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10-percent shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. 10-percent shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. 10-percent shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock.

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. A U.S. corporation also may be deemed to have paid taxes paid by a second- or third-tier foreign corporation if certain conditions are satisfied.

Description of Proposal

Lower-tier CFCs

Characterization of gain on stock disposition

Under the proposal, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain would be treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. This proposal, however, would not affect the determination of whether the corporation whose stock is sold or exchanged is a CFC.

Thus, for example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the proposal, any gain of the first corporation upon a sale or exchange of stock of the second corporation would be treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a CFC with respect to the U.S. shareholder.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having a substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the proposal, would not be excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

Under the proposal, for purposes of this rule, a CFC is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the CFC would be treated as having gain from the sale or exchange of such stock. Thus, for example, if a CFC distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the CFC under section 311(b) as if the stock were sold to the shareholder for fair market value, the proposal would make clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The proposal also would repeal a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 that, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. 10-percent shareholder of that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a 10/50 company. Thus, under the proposal, a CFC would not be treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC, whether or not the recipient of the distribution was a U.S. 10-percent shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

Under the proposal, when a lower-tier CFC earns subpart F income, and stock in that corporation is later disposed of by an upper-tier CFC, the resulting income inclusion of the U.S. 10-percent shareholders would, under regulations, be adjusted to account for previous inclusions, in a manner similar to the adjustments currently provided to the basis of stock in a first-tier CFC. Thus, just as the basis of a U.S. 10-percent shareholder in a first-tier CFC rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition of the stock of that company, the subpart F income from gain on the disposition of a lower-tier CFC generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier CFC.

For example, assume that a U.S. person is the owner of all of the stock of a first-tier CFC which, in turn, is the sole shareholder of a second-tier CFC. In year 1, the second-tier CFC earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier CFC disposes of the second-tier CFC's stock and recognizes $300 of income with respect to the disposition. All of that income would constitute subpart F foreign personal holding company income. Under the proposal, the Secretary would be granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100--the amount of year 1 subpart F income of the second-tier CFC that was included, in that year, in the U.S. person's gross income. Such an adjustment would, in effect, allow for a step-up in the basis of the stock of the second-tier CFC to the extent of its subpart F income previously included in the U.S. person's gross income.

Subpart F inclusions in year of acquisition

If a U.S. 10-percent shareholder acquires the stock of a CFC from another U.S. 10-percent shareholder during a taxable year of the CFC in which it earns subpart F income, the proposal would reduce the acquirer's subpart F income inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion would be reduced (as is currently the case if a dividend was paid to the previous owner of the stock) would not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Treatment of U.S. income earned by a CFC

Under the proposal, an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a CFC would not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a CFC earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S.

branch profits tax under a provision of an applicable U.S. income tax treaty. The proposal would provide that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Extension of indirect foreign tax credit

The proposal would extend the application of the indirect foreign tax credit (secs. 902 and 960) to taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements would be required to be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a CFC. Second, the U.S. corporation claiming the credit under section 902(a) must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The proposal would limit the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a CFC. Foreign taxes paid below the sixth tier of foreign corporations would remain ineligible for the indirect foreign tax credit.

Effective Dates

Lower-tier CFCs.--The provision of the proposal that would treat gains on dispositions of stock in lower-tier CFCs as dividends under section 1248 principles would apply to gains recognized on transactions occurring after the date of enactment.

The provision in the proposal that would expand look-through treatment, for foreign tax credit limitation purposes, of dividends from CFCs, would be effective for distributions after the date of enactment.

The provision in the proposal that would provide for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of CFCs from dispositions of stock in lower-tier CFCs would be effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1997. Thus, the proposal would permit regulatory adjustments to an inclusion occurring after the effective date to account for income that was previously taxed under the subpart F provisions either prior to or subsequent to the effective date.

Subpart F inclusions in year of acquisition.--The provision in the proposal that would permit dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year would be effective with respect to dispositions occurring after the date of enactment.

Treatment of U.S. source income earned by a CFC.--The provision in the proposal addressing the effect of treaty exemptions from, or reductions of, the branch profits tax on the determination of subpart F income would be effective for taxable years beginning after December 31, 1986.

Extension of indirect foreign tax credit.--The provision in the proposal that would extend application of the indirect foreign tax credit to certain CFCs below the third tier would be effective for foreign taxes paid or incurred by CFCs for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations, the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the proposal, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment would have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction.

2. Simplify formation and operation of international joint ventures

Present Law

Under section 1491, an excise tax generally is imposed on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax is 35 percent of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the section 1491 excise tax are available. Under section 1494(c), a substantial penalty applies in the case of a failure to report a transfer described in section 1491.

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

A partnership generally is considered to be a domestic partnership if it is created or organized in the United States or under the laws of the United States or any State. A foreign partnership generally is any partnership that is not a domestic partnership.

Description of Proposal

The proposal would repeal the sections 1491-1494 excise tax and reporting rules that apply to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applies under present law to transfers to a foreign estate or trust, gain recognition would be required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust. Instead of the excise tax that applies under present law to certain transfers to foreign corporations, regulatory authority would be granted under section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not described otherwise in section 367. Instead of the excise tax that applies under present law to transfers to foreign partnerships, regulatory authority would be granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority would be granted to deny the nonrecognition treatment that is provided under section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

The proposal would repeal the rule that treats as U.S. source income any deemed royalty arising under section 367(d). Under the proposal, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under section 367(d) would be treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority would be granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

The proposal would provide detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally would be required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations.

Under the proposal, reporting rules similar to those applicable under present law in the case of controlled foreign corporations would apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership would be required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner would be considered to control a foreign partnership if the partner holds a more than 50 percent interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership. Similar information reporting also would be required from a U.S. 10-percent partner of a foreign partnership that is controlled by U.S. 10-percent partners. A $10,000 penalty would apply to a failure to comply with these reporting requirements; additional penalties of up to $50,000 would apply in the case of continued noncompliance after notification by the Secretary of the Treasury. Under the proposal, the penalties for failure to report information with respect to a controlled foreign corporation would be conformed with these penalties.

Under the proposal, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, would be required only in the case of acquisitions, dispositions, or changes involving at least a 10-percent interest. A $10,000 penalty would apply to a failure to comply with these reporting requirements; additional penalties of up to $50,000 would apply in the case

of continued noncompliance after notification by the Secretary. Under the proposal, the penalties for failure to report information with respect to a foreign corporation would be conformed with these penalties.

Under the proposal, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations would apply in the case of transfers to foreign partnerships. These reporting rules would apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10-percent interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000. A penalty equal to 10 percent of the value of the property transferred would apply to a failure to comply with these reporting requirements. Under the proposal, the penalty for failure to report transfers to a foreign corporation would be conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also would result in gain recognition with respect to the property transferred.

Under the proposal, in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates would not expire before the date that is three years after the date on which such information is provided.

Under the proposal, regulatory authority would be granted to provide rules treating a partnership as domestic or foreign, where such treatment is more appropriate, without regard to where the partnership is created or organized.

Effective Date

The proposals with respect to the repeal of sections 1491-1494 would be effective upon date of enactment. The proposal with respect to the source of a deemed royalty under section 367(d) would be effective for transfers made and royalties deemed received after date of enactment.

The proposals regarding information reporting with respect to foreign partnerships generally would be effective for partnership taxable years beginning after date of enactment. The proposals regarding information reporting with respect to interests in, and transfers to, foreign partnerships would be effective for transfers to, and changes in interest in, foreign partnerships after date of enactment. Taxpayers could elect to apply these rules to transfers made after August 20, 1996 (and thereby avoid a penalty under section 1494(c)) and the Secretary could prescribe simplified reporting requirements for these cases. The proposal with respect to the statute of limitations in the case of noncompliance with reporting requirements would be effective for information returns due after date of enactment.

The proposal regarding the determination of the treatment of partnerships as foreign or domestic would be effective for partnership taxable years beginning after date of enactment.

3. Modification of reporting threshold for stock ownership of a foreign corporation

Present Law

Several provisions of the Code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or act as officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer, director or who owns at least 10 percent of the stock of a foreign corporation that is a controlled foreign corporation or a foreign personal holding company to file Form 5471 annually.

Section 6046 mandates the filing of information returns by certain U.S. persons with respect to a foreign corporation upon the occurrence of certain events. U.S. persons required to file these information returns are those who acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership.

A failure to file the required information return under section 6038 could result in monetary penalties or reduction of foreign tax credit benefits. A failure to file the required information returns under sections 6035 or 6046 could result in monetary penalties.

Description of Proposal

The proposal would increase the threshold for stock ownership of a foreign corporation that results in information reporting obligations under section 6046 from 5 percent (based on value) to 10 percent (based on vote or value).

Effective Date

The proposal would be effective for reportable transactions occurring after December 31, 1997.

4. Simplify translation of foreign taxes

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession. This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or has an income

inclusion from the foreign corporation.

Redetermination of foreign taxes

For taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. If a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arises. A foreign tax redetermination may occur in the case of a refund of foreign taxes. A foreign tax redetermination also may arise because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. In addition, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. The Treasury regulations provide exceptions to this rule for de minimis cases. In the case of a redetermination of foreign taxes that qualify for the indirect (or "deemed-paid") foreign tax credit under sections 902 and 960, the Treasury regulations generally require taxpayers to make appropriate adjustments to the payor foreign corporation's pools of earnings and profits and foreign taxes.

Description of Proposal

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued, the proposal generally would provide for foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. This rule would not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).

Translation of all other foreign taxes

Under the proposal, foreign taxes not eligible for application of the preceding rules generally would be translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The proposal would provide the Secretary of the Treasury with authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

Redetermination of foreign taxes

Under the proposal, a redetermination would be required if: (1) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or (3) any tax paid is refunded in whole or in part. Thus, for example, the proposal provides that if at the close of the second taxable year after the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) would be required for the amount representing the unpaid portion of that accrued tax. In other words, the previous accrual of any tax that is unpaid as of that date would be denied. In cases where a redetermination is required, as under present law, the proposal specifies that the taxpayer must notify the Secretary, who would redetermine the amount of the tax for the year or years affected. In the case of indirect foreign tax credits, regulatory authority would be granted to prescribe appropriate adjustments to the foreign tax pools in lieu of such a redetermination.

The proposal provides specific rules for the treatment of accrued taxes that are paid more than two years after the close of the taxable year to which such taxes relate. In the case of the direct foreign tax credit, any such taxes subsequently paid would be taken into account for the taxable year to which such taxes relate, but would be translated into U.S. dollar amounts using the exchange rates in effect as of the time such taxes are paid. In the case of the indirect foreign tax credit, any such taxes subsequently paid would be taken into account for the taxable year in which paid, and would be translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that the currency involved is not inflationary . Further assume that as of the end of year 1 the tax is unpaid. In this case, the proposal would provide that the taxpayer would translate 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1. If the 1,000 units of tax were paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax would be required. If any portion of the tax so accrued remained unpaid as of the end of year 3, however, the taxpayer would be required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer paid the disallowed taxes in year 4, the taxpayer would redetermine its foreign taxes (and foreign tax credit) for year 1 to take into account the taxes paid in year 4, but the taxes paid in year 4 would be translated into U.S. dollars at the exchange rate for year 4.

Effective Date

The proposal generally would be effective for foreign taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1997. The proposal's changes to the foreign tax redetermination rules would apply to foreign taxes which relate to taxable years beginning after December 31, 1997.

5. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Description of Proposal

The proposal would permit taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Under this election, foreign source regular taxable income would be used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, it is intended that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess.

The election would be available only in the first taxable year beginning after December 31, 1997, for which the taxpayer claims an AMT foreign tax credit. It is intended that a taxpayer would be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election, once made, would apply to all subsequent taxable years, and could be revoked only with the consent of the Secretary of the Treasury.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

6. Simplify application of the stock and securities trading safe harbor

Present Law

A non-resident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the trade or business, at graduated rates of tax. Under a "safe harbor" rule,

foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business for this purpose.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. In addition, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

For foreign persons who invest in securities trading partnerships, the safe harbor applies only if the partnership is not a dealer in stock and securities. In addition, if the principal business of the partnership is trading stock or securities for its own account, the safe harbor generally does not apply if the principal office of the partnership is in the United States.

Under Treasury regulations which apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account (Treas. reg. secs. 1.864-2(c)(2)(ii) and (iii)). Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

Description of Proposal

The proposal would modify the stock and securities trading safe harbor by eliminating the requirement for both partnerships and foreign corporations that trade stock or securities for their own account that the entity's principal office not be within the United States.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

7. Simplify foreign tax credit limitation for individuals

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments. Taxable income of this type ordinarily is includible in the single foreign tax credit limitation category for passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in one of several other separate

limitation categories (e.g., high withholding tax interest income or general limitation income). For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Description of Proposal

The proposal would allow individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, an exemption from the foreign tax credit limitation rules. (It is intended that an individual electing this exemption would not be required to file Form 1116 in order to obtain the benefit of the foreign tax credit.) An individual making this election would not be entitled to any carryover of excess foreign taxes to or from a taxable year to which the election applies.

For purposes of this election, passive income generally would be defined to include all types of income that is foreign personal holding company income under the subpart F rules, plus income inclusions from foreign personal holding companies and passive foreign investment companies, provided that the income is shown on a payee statement furnished to the individual. For purposes of this election, creditable foreign taxes would include only foreign taxes that are shown on a payee statement furnished to the individual.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

8. Simplify treatment of personal transactions in foreign currency

Present Law

When a U.S. taxpayer makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") generally arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss also can arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use while traveling abroad realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the

Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies.

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988 of the Code, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions are deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.

Description of Proposal

Under the proposal, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, nonrecognition treatment would apply to any resulting exchange gain, provided that such gain does not exceed $200. The proposal would not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

9. Transition rule for certain trusts

Present Law

Under rules enacted with the Small Business Job Protection Act of 1996, a trust is considered to be a U.S. trust if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, U.S. fiduciaries of the trust must have the authority to control all substantial decisions of the trust. A trust that does not satisfy both of these criteria is considered to be a foreign trust. These rules for defining a U.S. trust generally are effective for taxable years of a trust that begin after December 31, 1996. A trust that qualified as a U.S. trust under prior law could fail to qualify as a U.S. trust under these new criteria.

Description of Proposal

Under the proposal, the Secretary of the Treasury would be granted authority to allow nongrantor trusts that had been treated as U.S. trusts under prior law to elect to continue to be treated as U.S. trusts, notwithstanding the new criteria for qualification as a U.S. trust.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1996.

10. Clarification of determination of foreign taxes deemed paid

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings. The foreign corporation's post-1986 foreign income taxes is the sum of the foreign income taxes with respect to the taxable year in which the dividend is distributed plus certain foreign income taxes with respect to prior taxable years (beginning after December 31, 1986).

Description of Proposal

The proposal would clarify that, for purposes of the deemed paid credit under section 902 for a taxable year, a foreign corporation's post-1986 foreign income taxes would include foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. No inference would be intended regarding the determination of foreign taxes deemed paid under present law.

Effective Date

The proposal would be effective on date of enactment.

11. Clarification of foreign tax credit limitation for financial services income

Present Law

Under section 904, separate foreign tax credit limitations apply to various categories of income. Two of these separate limitation categories are passive income and financial services income. For purposes of the separate foreign tax credit limitation applicable to passive income, certain income that is treated as high-taxed income is excluded from the definition of passive income. For purposes of the separate foreign tax credit limitation applicable to financial services income, the definition of financial services income generally incorporates passive income as defined for purposes of the separate limitation applicable to passive income.

Description of Proposal

The proposal would clarify that the exclusion of income that is treated as high-taxed income does not apply for purposes of the separate foreign tax credit limitation applicable to financial services income. No inference would be intended regarding the treatment of high-taxed income for purposes of the separate foreign tax credit limitation applicable to financial services income under present law.

Effective Date

The proposal would be effective on date of enactment.